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Intelligence Memorandum

Taiwan: The Economic Impact of Growing Political Isolation

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
January 1972

INTELLIGENCE MEMORANDUM

**TAIWAN: THE ECONOMIC IMPACT
OF GROWING POLITICAL ISOLATION**

Introduction

1. The loss of its UN seat was the most dramatic of several political setbacks surrounding the China issue that hit Taiwan in 1971. One immediate result of the October UN decision was a sharp decline in investor confidence, which threatened to disrupt the heavy inflows of foreign capital that have been critical to Taiwan's export-led economic boom. The island's reduced political status raised questions about its position in the world economy and fears over the possibility of economic isolation. This memorandum reviews and evaluates Taipei's initial moves and longer range plans to offset the negative impact of political developments. It also assesses the likely impact of these developments on the Taiwanese economy.

Discussion

Economic Dynamics

2. Over the past decade, Taiwan has achieved one of the most impressive growth records among the less developed countries (LDCs). (For selected economic data, see Table 1.) The economy has grown at an average real rate of about 10% annually. This rapid growth boosted per capita gross national product in 1971 to more than US \$400 - about double the world average for LDCs - and has led to a substantial improvement in living standards. Consumption of goods and services has increased greatly. Schools and medical care now are widely available; the 75% literacy rate achieved by 1970 was among the highest in Asia. Life expectancy and infant mortality rates have steadily improved and are now comparable with those in the United States.

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

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Table 1

Taiwan: Selected Economic Data a/

Gross national product (GNP), 1971 (Billion US \$)	6.2
Population, 1971 (Million)	15
Per capita GNP, 1971 (US \$)	410
Average annual growth of GNP, 1961-71 (Percent)	10
Total exports, 1971 (Billion US \$)	2.1
Average annual growth of exports, 1961-71 (Percent)	26

a. Data for 1971 are estimated.

3. At the forefront of economic development has been a booming, export-oriented manufacturing sector.* Exports of manufactures expanded at the phenomenal rate of 35% annually between 1960 and 1970, and Taiwan now ranks second only to Hong Kong as the largest exporter of manufacturers among LDCs. Overall exports jumped dramatically, from only \$170 million in 1960 to more than \$2 billion in 1971, with manufactures such as textiles, clothing, and electronic products making up most of the increase. This striking performance has been the biggest factor in transforming resource-poor Taiwan from a predominantly agricultural economy to one of the world's most dynamic manufacturing centers. The country is no longer dependent on foreign aid; indeed, it has undertaken a small aid program for other LDCs.

4. The key to this achievement has been Taipei's successful effort to attract large amounts of private foreign investment into new export industries. This effort began in the early 1960s, when Taiwan's small domestic market and limited natural resources became a growth constraint. Taipei established liberal investment laws, export subsidies, and bonded

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export zones where imported materials and exported products could move duty free. These measures, combined with Taiwan's low-wage, well-educated, and highly-disciplined labor force, have made the island an ideal location for foreign firms seeking refuge from rising wages at home. Another crucial factor has been the island's political stability.

5. The advantages offered foreign investors have attracted an increasing inflow of foreign capital. Inflows of long-term private investment averaged more than \$125 million annually during 1968-70, compared with only a \$14 million average during 1960-62. This foreign capital has come largely from American, Japanese, and overseas Chinese sources and has consisted mainly of long-term loans used to purchase machinery and other needs. The share of equity capital in the inflow is relatively small. Foreign firms also have provided the technical know-how, management techniques, and access to overseas markets that have been so essential to Taiwan's success. From a balance-of-payments point of view, Taiwan has achieved the enviable position of having both a current account surplus and a sizable net long-term capital inflow, which in 1971 yielded an estimated \$400 million basic balance surplus.

Impact of the UN Vote

6. The inflow of foreign capital, which has proved so vital to Taiwan's economic development, was threatened by investor uncertainty following the October UN vote. This uncertainty was most dramatically reflected in an illegal outflow of capital, mainly to Hong Kong and Singapore. Some estimates put this inflow as high as \$100 million in the month following the UN action although it is probably much less. Efforts to convert New Taiwan dollars into US dollars* pushed the black market rate in Taipei as high as NT\$50 to US \$1, representing a 20% depreciation from the currency's par value of NT\$40 to US \$1. Moreover, the local gold price rose considerably, and prices of local securities declined.

7. Taipei moved quickly to counteract the growing crisis of confidence in the island's political and economic future. The government supported its currency by pumping US dollars into the black market and succeeded in eliminating the unusually high black market rate. The central bank bolstered falling stock prices by purchasing securities and taking steps to facilitate the financing of private stock purchases. In addition, Taiwanese officials publicly emphasized the country's favorable economic outlook and elicited statements from foreign investors stressing the favorable economic prospects.

* The Taiwan government, through the central bank, tightly controls outflows of foreign exchange, thus forcing residents who wish unrestricted amounts of foreign exchange into the black market.

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8. Taipei's well-orchestrated actions have gone a long way to overcome the initial impact of the UN vote. Capital flight apparently has been halted, and some funds that fled the country in October and November probably have returned. Many foreign firms are once again moving ahead with investment plans. In early December, a US firm announced plans for a \$10 million investment, ending the lull in investor interest. An Austrian firm recently signed a preliminary contract for a \$320-million integrated steel mill, which would be Taiwan's largest undertaking, and several overseas Chinese firms have significantly increased their planned investments in the past few months. This surge in investment boosted total investment approvals in 1971 to a record \$163 million, up 16.5% over the 1970 level.

The Threat of Economic Isolation

9. While Taipei has successfully countered the initial economic effects of its political setback, it still faces the long-term threat that its diminished political status might bring economic isolation. The government thus has started trying to assure the continued inflow of foreign capital and continued access to overseas markets. As a first step, Taipei has begun acting more quickly and liberally on foreign business proposals. While relatively sophisticated, capital-intensive enterprises are preferred, Taipei has indicated that it will continue to welcome the simpler assembly operations that investors have traditionally favored. Efforts are also being made to reduce the red tape that in the past has deterred some investors.

10. To help secure its position in foreign markets, Taipei is moving to expand and diversify its trade. The government is drawing up plans for a worldwide trade offensive, which emphasizes increased sales to Europe and the less developed world where only limited inroads have been made. Taiwan's trade still is dominated by the United States and Japan, which together account for more than 50% of exports (see Table 2). Diversification was given a boost by a recently concluded deal with Indonesia, which will increase two-way trade in 1972 by about 50% over the current level.

11. Even in those countries that now recognize only Peking, Taipei is stepping up efforts to maintain or establish economic ties. After Canada and Italy established diplomatic relations with the People's Republic of China (PRC) in late 1970, Taiwan kept its trade missions in place, and trade with both countries continued to increase. In fact, data for the first half of 1971 show that exports to Canada jumped an extraordinary 68% over the same period in 1970. In its dealings with Canada, Taipei has deliberately avoided using a regular government agency and the island's formal name; it works instead through the quasi-official Far Eastern Trading Company. If Taipei believed it to be necessary, a similar policy would likely be adopted in trading with European countries that recognize the PRC. In Latin American and African countries where diplomatic recognition has

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been lost, Taipei plans to establish private, non-profit, government-supported companies to handle trade, investment, and technical cooperation.

Table 2

Taiwan: World Trade Pattern
1970

<u>Country</u>	<u>Percent</u>	
	<u>Share of Taiwan's Exports</u>	<u>Share of Taiwan's Imports</u>
United States	37	30
Japan	15	38
Western Europe	10	9
Other developed countries	5	18
Less developed countries	33	5

12. Finally, Taipei hopes to strengthen its position in the specialized international agencies. Although Taiwan was expelled from the General Agreement on Tariffs and Trade (GATT) after the UN vote, its position in the International Monetary Fund (IMF), the Asian Development Bank (ADB), and the World Bank appears secure. Legal experts of these UN-affiliated organizations believe that they are not bound by the General Assembly vote. This situation could be endangered, however, by the evolution of attitudes by members of these bodies. As a hedge against possible expulsion from the IMF, Taipei withdrew its \$60 million gold share of its IMF subscription a week before the UN vote. In any event, Taipei's continued membership in these agencies is largely a matter of prestige. In recent years, borrowing from international economic agencies has averaged only \$24 million annually, and this capital could easily be replaced from private sources.

Peking's Ability to Influence Foreign Investors

13. While the PRC's longstanding effort to isolate Taiwan from its commercial partners has been encouraged by the UN vote, the leverage available to accomplish this remains limited. Peking has attempted to

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discourage foreign firms from doing business with Taiwan by holding out the prospect of the mainland's vast trade potential. This ploy has had little impact, however, since the PRC's trade prospects are not especially inviting in the next few years at least. Trade continues to be constrained by Peking's emphasis on economic self-sufficiency and balanced trade and by the PRC's inability to offer a wide range of desirable exports. In addition, Peking's efforts to minimize foreign indebtedness probably will continue to preclude the use of foreign credits as a means of boosting trade.

14. The PRC's efforts have been largely directed at Japan, Taiwan's leading trading partner. Peking's recent political triumphs have put Tokyo under increased pressure from local pro-Peking business elements, which stress that Japan's long-term business interests are best served by dealing with the PRC rather than Taiwan. Tokyo's increasing sensitivity to this pressure is reflected in the go-slow approach adopted in 1971 on aid to Taiwan. The Japanese refused a Taipei request for a \$250 million line of credit, stating that they would honor previous aid commitments but not grant new assistance in the foreseeable future. In addition, most major Japanese firms are increasingly accepting Chou En-lai's "four principles," governing Peking's foreign economic relations. These principles would bar Japanese firms having close relations with Taiwan or South Korea from trading with the PRC.

15. The economic impact of Japan's concessions is likely to be limited, however. Some Japanese firms are circumventing the intent of the "four principles" by establishing dummy firms to deal with Taiwan -- a practice long used in trading with the PRC. This and other such subterfuges are likely to ensure a continuation of substantial Japanese trade with Taiwan and Japanese private investment there, despite the recent government decision to avoid new aid commitments.

16. Thus, while the Japanese are willing to maintain a low economic profile on Taiwan in deference to Peking, they remain reluctant to reduce their lucrative presence on the island. In addition to investing in Taiwan's profitable export industries, Japan supplies most of the island's industrial inputs and technology, and Tokyo-based trading companies handle nearly half of the foreign trade. Last year, trade between the two countries, according to preliminary estimates, totaled about \$1.2 billion and yielded Tokyo nearly a \$600 million surplus. Japan's trade with Taiwan is still larger than that with the PRC, which approximated \$900 million in 1971 and favored Japan by about \$300 million. Japan's actual exports and imports with the two Chinas for the first 11 months of 1971 were as follows:

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<u>Country</u>	<u>Million US \$</u>	
	<u>Exports</u> <u>(F.O.B.)</u>	<u>Imports</u> <u>(C.I.F.)</u>
Taiwan	821	262
PRC	516	284

17. In the unlikely event that Japan reduces its economic involvement with Taiwan, the gap probably would be quickly filled by other countries. US and European firms particularly have maintained their high interest in Taiwan, largely because it continues to offer one of the few opportunities to compete effectively with Japanese manufacturers. Indeed, much of the record level of 1971 investment approvals reflected European investment plans. Meanwhile, US firms continue to transfer domestic manufacturing operations to the island in increasing numbers. US and European investment is warmly welcomed by Taipei anyway because of its fears of becoming overly dependent on Japan.

Prospects and Conclusions

18. Taiwan's recent political setbacks have had little economic impact so far and do not threaten to be particularly damaging in the future. The large capital flight that followed Taipei's expulsion from the UN in October has been halted, and investor confidence in the country's political stability and favorable economic prospects seems as strong as ever. Indeed, after an initial lull following the UN vote, the government's foreign investment approvals are again on the rise even though some investors may be holding back until the results of President Nixon's Peking visit are known. The long-term threat of economic isolation is not a very serious one either. Taipei has been careful to protect its economic interests even in countries that have broken diplomatic relations, and it seems determined to maintain this policy. Although Peking can be expected to intensify efforts to isolate Taiwan from its commercial partners, these attempts are not likely to be any more successful than in the past.

19. Taiwan thus has come out of the China debate in a good economic position, and the outlook for the economy generally remains very bright. The island offers some marked advantages for foreign investors, and foreign capital inflows are expected to continue at relatively high levels so long as favorable economic policies continue. The recent international monetary adjustments have even improved the economic outlook, since Taiwan followed the United States in devaluing. This action has given Taiwan a further edge over Japan and Hong Kong -- two of its major competitors -- in world markets as well as improving its competitive position in the Japanese

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domestic market. This should further entice export-oriented investment into Taiwan. In short, Taiwan is in an excellent economic position to cope with Peking's increased presence on the world scene.

20. Even if future political developments slow the inflow of foreign capital and technology, Taiwan is in an excellent position to weather the storm. Projections based on past development trends indicate that even if the level of private long-term capital inflow should decline to \$100 million annually – about 70% of the level of recent years – Taiwan would continue, at least through 1975, to have a trade surplus and sufficient foreign exchange earnings to support an economic growth rate near the current level.* This prospect derives from the fact that inflows of foreign investments, which largely go into export industries, would reduce Taiwan's export capability but at the same time would lower its need for imports of capital equipment and industrial supplies and of intermediate products. In addition much of the large investment of recent years has not reached its full export potential; therefore, it would be several years before any reduced investment would have much of an impact on output. Any further adjustment to a reduced volume of foreign capital inflows could be facilitated by drawing on Taiwan's net foreign asset holdings, which totaled about \$800 million at the end of 1971.

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